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Pricing the "Luxury Product"

New York City Taxes Under Mayor Bloomberg

E. J. McMahon

Senior Fellow,
The Manhattan Institute for Policy Research

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CENTER FOR CIVIC INNOVATION
AT THE MANHATTAN INSTITUTE

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Executive Summary

The last four years have seen a remarkable turnabout in tax policy of New York City. Considerable progress was made in reducing tax rates and the overall tax burden under former Mayor Rudolph Giuliani, from 1994 through 2001. But since 2002, the city under Mayor Bloomberg has raised taxes by up to $3 billion, two-thirds of which consisted of a record property tax hike.

The negative economic consequences of such large tax hikes were at least temporarily offset by the positive impact of a large federal tax cut that included especially large benefits both for New York residents and for Wall Street, the city's key industry. But as time goes on, the city risks paying a heavier price for its failure to hold down taxes. Moreover, the existing complexities and inefficiencies of the tax system have been exacerbated in the course of recent tax law changes, such as the $400 property tax "rebate" for homeowners.

Mayor Bloomberg has defended his tax hikes as the necessary price of maintaining essential services in what will always be a high-cost city. The question, however, is whether the price was far too high to begin with. In their bids to replace Bloomberg, the leading Democratic candidates in the 2005 mayoral race tended to focus on additional proposals for raising and redistributing the city tax burden, rather than on reducing it.

This report summarizes recent trends in New York City's tax policy, the shape of recent tax increases and their impacts, and the relative size of the tax burden. It also identifies priorities and prospects for change in the future.

About the Author

E. J. McMahon is a Senior Fellow for Tax and Budgetary Studies at the Center for Civic Innovation at the Manhattan Institute. Mr. McMahon studies the tax and spending policies of New York City and New York State and issues recommendations on how these policies can be reformed to increase economic growth. Prior to joining the Institute, Mr. McMahon was Vice Chancellor for External Affairs at the State University of New York. He has also served as Deputy Commissioner for Tax Policy Analysis and Counselor to the Commissioner in the state Department of Taxation and Finance; Director of Minority Staff for the state Assembly Ways and Means Committee; and Research Director for the Public Policy Institute of New York State.

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"If New York City is a business, it isn't Wal-Mart — it isn't trying to be the lowest-priced product in the market. It's a high-end product, maybe even a luxury product. New York offers tremendous value, but only for those companies able to capitalize on it."[1]
— Mayor Michael Bloomberg, prepared text for economic policy speech, January 2003.

Confronted with enormous budget gaps upon taking office almost four years ago, Mayor Bloomberg soon resorted to a series of significant city tax increases that represented a 180-degree turn from the tax-cutting policies of his predecessor.

The city tax hikes of 2002 and 2003 wiped out $2.7 billion in annual resident taxpayer savings enacted just a few years earlier, during the tenure of former Mayor Rudolph Giuliani. This taxing turnabout on the city level was compounded by simultaneous "temporary" increases in New York State personal income and sales tax rates. On the heels of a national recession, the World Trade Center attack and the fall in the stock market, the stage seemed to be set in New York for a downward economic spiral reminiscent of the early 1990s.

But just as Albany and City Hall were raising taxes, President Bush and Congress were agreeing to accelerate federal income tax rate cuts and to add new investment incentives boosting the stock market. This action alone packed a wealth- and job-creation punch that more than offset the negative impact of the state and city tax increases, a new econometric model confirms. Ignited by falling interest rates, the billions in net tax savings added more fuel to a real estate boom of historic proportions, which in turn fed the city's capital gains and real estate transaction taxes.

Two years later, with a new mayoral term approaching, there are no new federal tax cuts on the horizon (if anything, the risk is quite the opposite). Interest rates are rising and the real estate market appears to be cooling. As these positives wane, the negative aspects of the city's tax policies once again loom large in any assessment of New York's growth prospects. This paper highlights several key concerns for the future:

- Relative to personal income, city taxes have climbed back to the average levels of the 1980s and early '90s.
- By almost any comparative measure, New York's city tax burden is significantly heavier than those of surrounding jurisdictions and of other major cities. This was true even *before* the latest round of tax hikes.
- The city is excessively dependent on the most volatile and economically sensitive portions of its tax base, especially the personal income tax — which means even a mild downturn is more likely to translate into another serious fiscal crisis.

In defense of his policies, the Mayor has suggested that high taxes are less of a hindrance to economic development in New York than in other cities. But his image of New York as a "high-end … luxury product" ultimately amounts to a strong argument against continuing indifference to high marginal tax rates. After all, it is a well-established economic principle that demand for luxury goods is highly elastic. When prices rise too high, especially in a pinch, consumers (or, in this case, footloose firms and individuals) forgo luxuries before necessities.

To continue with Bloomberg's merchandising analogy, the challenge facing city officials on the tax policy front is not so much to under-price the competition but to find a winning price point for the "product" New York represents. This translates a mix and level of taxes that will promote sustained economic growth and stable city finances.

Ghosts of tax hikes past

For most of New York's modern history, city taxes headed in one direction – up. Yet repeated waves of significant tax increases in the second half of the 20th century failed to prevent the City from going broke. Indeed, high taxes contributed to the massive loss of jobs and businesses that brought the great New York City fiscal crisis to a head in 1975.[2]

In the aftermath of that brush with municipal bankruptcy, the Koch Administration enacted a series of targeted reductions in business taxes. Responding to federal tax changes, the City also launched a reform of its own income tax structure. But when fiscal push came to shove with the economic slowdown of 1990, the City under Mayor David Dinkins starting raising taxes again—enacting, in quick succession, two surcharges that added more than 28 percent to personal income tax bills, and a major property tax hike. A 1991 study by then-City Comptroller Elizabeth Holtzman predicted that over 100,000 jobs would be lost as a result of these increases.[3] In fact, employment dropped by over 300,000 before the economy hit bottom in 1993.

Change in course

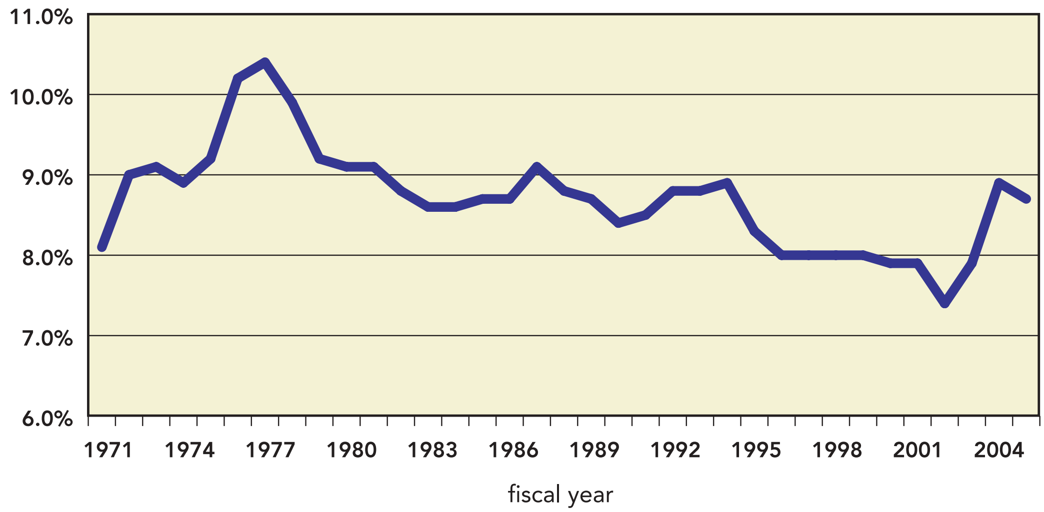
Rudolph Giuliani brought to office a dramatically different approach. Among other things, he was the first mayor in New York's modern history to attach a high priority to city tax reduction – usually with the support of Council Speaker Peter Vallone.[4]

By the end of Giuliani's tenure, New York residents and businesses were saving $2.2 billion a year from city tax cuts initiated over the previous eight years, including tax cuts enacted as part of the mayor's final city budget.[5] An additional $500 million in targeted property and city personal income tax relief was generated by the state-financed School Tax Reduction (STAR) program – bringing city residents' total savings to $2.7 billion. When state tax reductions are considered part of the mix, the changes enacted between 1994 and 2002 saved city taxpayers at least $6 billion a year in current terms.[6]

The size of the overall burden is illustrated in Figure 1, which shows the long-term trend in city taxes as a percentage of New Yorkers' personal income.[7] After peaking at over 10 percent in 1977, the average tax burden averaged 8.7 percent during Edward Koch's last two terms (1982-89) and Dinkins' single term as mayor (1990-93). Under Giuliani, the average dropped to 8 percent, hitting a 30-year low in 2001.[8] (The difference of seven-tenths of a percentage point may sound tiny, but relative to $342 million in personal income as of 2001, it equated to over $2 billion.)

The era of tax reduction in New York effectively came to end on Sept. 11, 2001, when the World Trade Center attack blew a huge hole in the city budget. Indeed, taxes were raised while the smoke was still rising from Ground Zero. In a lame-duck session a few weeks before Bloomberg took office as mayor, the City Council (with Giuliani's tacit support) failed to take a vote needed to extend an income tax cut it had approved just six months earlier.[9] By default, 2002 began with the first city income tax rate increase in 10 years.

Figure 1. City Taxes as a Share of Personal Income, 1971-2005



Source: City of New York, Office of Management and Budget, U.S. Commerce Department Bureau of Economic Affairs

TAX HIKES SINCE 2002

Repeating a campaign theme, Bloomberg declared in his January 2002 inaugural: "We cannot raise taxes. We will find another way."

Nonetheless, it took little more than a month for the mayor to propose his first tax increase – a hike in cigarette tax, from 8 cents to $1.50 per pack. This change was originally designed to raise $250 million a year in new revenue, but the mayor focused on the public health aspects of the issue. "We all know that smoking kills," he said. "And increasing the cigarette tax saves lives."[10] Increasing the cigarette tax would also lead to a new wave of tax avoidance by smokers – which meant that Albany's permission to hike the rate would come at a price.

In January of 2002, the state had approved an increase in its own cigarette tax, to $1.50 per pack, to be effective April of that year. The proposed city increase would take effect four months later, on July 1. Boosting the combined state and local cigarette tax by 152 percent would lead to an immediate and steep drop-off in taxable sales within the five boroughs – New York State's largest cigarette market. This, in turn, would dramatically reduce revenue the state was counting on to help underwrite finance a huge expansion of health care spending. Thus, in the end, Bloomberg had to strike a deal to share 46 percent of the revenue from the city's tax increase with Albany before the Legislature and Governor Pataki would agree to it.

In the first year after the increase, taxable cigarette sales in the city dropped by nearly half – from 342 million to 182 million packs – which had been duly anticipated in the city's revenue estimate. By fiscal 2005, out of $228 million in added city taxes paid by smokers, the city budget's net take was $123 million, down 16 percent from the 2003 level.[11]

With the highest cigarette taxes in the country, New York also became fertile ground for illegal cigarette trafficking in the northeast states. By mid-2004, federal Alcohol, Tobacco and Firearms (ATF) officials told the Washington Post that smugglers with ties to terrorist groups were funneling the proceeds of illegal cigarette sales to organizations such as al Qaeda and Hezbollah. The Post article explained how high taxes helped such schemes:

> In New York City, for example, where the combined state and city tax on cigarettes is $3 a pack, a carton can sell for about $75. The trafficker can buy a carton for about $20 in Virginia, where the tax is 2.5 cents a pack, and then sell it to a mom-and-pop store in New York at a profit of about $40 a carton, ATF officials said.[12]

The November 2002 tax blowout

Through the spring and summer of Bloomberg's first year as mayor, the stock market continued to sink, along with the capital gains and wage income of the city's wealthiest taxpayers and the prospective bonuses of Wall Street workers. As a result, within a few months of its adoption, it was apparent that the hole in city's fiscal 2003 budget was growing larger than expected.

In November 2002, Bloomberg proposed a new plan to close gaps projected at over $1 billion for fiscal 2003 and $6.4 billion for 2004. Needing an immediate cash infusion and unwilling to resort to deeper spending cuts, the mayor had no choice but to call for an increase in the property tax – the only major revenue source that the City Council has the power to raise by local law. (Changing the rates of the city's other taxes requires a change in state law.)

While the mayor's proposal for higher property taxes was not a surprise under the fiscal circumstances, the size of the proposed rate hike was eye-popping at 25 percent. The City Council ultimately whittled this down to 18.5 percent – still big enough to qualify as the biggest in New York's history. And once approved, it was quick in coming: the first half of the increase was reflected in property tax bills issued in January 2003, and the second half in bills issued the following July.

While the tax rate had been frozen for the previous decade, assessments had continued to rise with property values, subject to a welter of complex assessment growth caps and "class share adjustments" manipulated to the limits of state law by the City Council in order to minimize impacts on homeowners. Nonetheless, the increase prompted widespread complaints and criticism from affected city residents.

Reshuffling the city tax deck

As part of his November 2002 modifications, Bloomberg also sought to revive the city's commuter tax, which had been repealed by the state in 1999 over the strenuous objections of Giuliani and Vallone. [13]

Before its repeal, the tax had been set at 0.45 percent of wages and 0.65 percent of self-employment income. Unlike the regular income tax, with its graduated rate schedule for different income brackets, the commuter tax was a flat rate applied to a worker's entire city income. This meant it could raise a commuter's New York State income tax bill[14] by 10 percent or more, depending on his or her level of income.

Bloomberg's original 2003 "income tax reform" proposal called for raising $1 billion by restoring the commuter tax at a rate of 2.7 percent, six times higher than the previous level. To soften the blow of the property tax hike, he wanted to use the proceeds to finance a phased-in, 38 percent reduction in the city resident income tax. In effect, he was asking suburbanites to fill the city's budget hole in the short-term and to underwrite a tax break for city residents in the long term.

This plan predictably was dead on arrival in both the Senate and the Assembly. Instead, in a fiscal 2004 state budget passed over Pataki's vetoes, the two houses joined forces to raise about $1.1 billion in new revenue for the city's 2004 budget as part of a package simultaneously hiking personal income and sales taxes on both the state and city levels.

The sales tax increases were straightforward enough. They consisted of an added 0.25 percent (one-quarter point) on the state's tax and 0.162 percent (one-eighth of a point) on the city tax, bringing the city's rate to 4.125 percent and the combined sales tax on purchases in the city to 8.625 percent. Both rates took effect July 1, 2003, and were set to expire on July 1, 2005. For the city alone, this change was designed to raise $131 million a year, according to the Independent Budget Office (IBO). The Legislature also ended a state and city sales tax exemption for clothing items costing under $110, as of June 1, 2003. This amounted to a $200 million city tax increase.

The state and city income tax increases were more complex. Legislators and city officials described them as "surcharges" on upper-income taxpayers, implying they were simply adding to existing top rates in both the state and city tax codes. In fact, this was a misnomer. The changes amounted to something far more costly and complicated from the standpoint of affected taxpayers.

Stealth income tax hikes

Under the 2003 legislation, the state and city each added two income tax rate brackets, retroactive to Jan. 1, 2003. The highest bracket, set at 7.7 percent on the state income tax and 4.45 percent on the city tax, applied to taxable incomes above $500,000 for all filers. The second highest bracket of 7.5 percent on state taxes and 4.25 percent on city taxes applied to incomes above $150,000 for married filers (or $100,000 for singles and $125,000 for heads of households). This produced a combined top rate of 12.15 percent, compared to 10.5 percent under the prior law. The top rates were scheduled to remain in effect for three full years, expiring at the end of 2005; the second-highest rates were to be phased out over the next two years.

The following table illustrates the change in rates enacted in 2003.

Table 1. New York City Income Tax Rates by Tax Bracket (Temporary Rates in Boldface)

Tax Brackets for Joint Filers	2002	2003	2004	2005	2006
Up to $21,600	2.91%	2.91%	2.91%	2.91%	2.91%
$21,601-$45,000	3.53%	3.53%	3.53%	3.53%	3.53%
$45,000-$90,000	3.59%	3.59%	3.59%	3.59%	3.59%
$90,000-$150,000	3.65%	3.65%	3.65%	3.65%	3.65%
$150,000-$500,000	3.65%	**4.25%**	**4.15%**	**4.05%**	3.65%
Over $500,000	3.65%	**4.45%**	**4.45%**	**4.45%**	3.65%

Source: City of New York Office of Management and Budget

If these rates had applied in a standard graduated fashion, the effects on many households just above the new income thresholds would be minimal. For example, the second highest state and city rate was a combined 1.25 percent higher than the 2002 rate, equating to just $12.50 on the first $1,000 of added income for a city resident, or $6.50 taxpayers living outside the city.

But simply adding a bracket or two to the existing tax structure would not have met the city's revenue targets – which originally called for close to $1 billion from the income tax alone. So Bloomberg and the Legislature agreed on an arcane tax law twist designed to minimize the apparent rate hike while aiming a larger tax at households earning taxable incomes between $150,000 and $500,000.

The details were extremely complicated, but the result was that the new, temporary top New York City rate of 4.45 percent applied, like a flat rate, to all of the income of taxpayers earning more than $500,000. For taxpayers earning less than $500,000 but more than $150,000 (or less for singles and heads of households), the second highest rate became a flat rate in similar fashion. This boosted the minimum tax increase to $1,115 for all city taxpayers earning between $200,000 and $500,000, and to $2,115 for taxpayers in the highest bracket. Incredibly, high-income taxpayers in New York City were thus subject to effective marginal rates of up 200,000 percent on their first dollar of added income above $500,000.[15] The resulting revenue increase initially was estimated by the IBO at $784 million in 2004.

Washington to the Rescue

The state and city income tax hikes, retroactive to Jan. 1, 2003, were first reflected in withholding tables during the first week in July. But that same week, New York taxpayers also began feeling the effects of a big new federal tax cut enacted at roughly the same time as the city increase.

The new federal law – the Jobs and Growth Tax Reform Reconciliation Act, or JGTRRA — included:

- Acceleration of changes adopted in 2001 but not scheduled to become fully effective until 2006, including marginal rate reductions, marriage penalty relief and an increase in the child credit, making all of these provisions fully effective in 2003.
- Immediate reduction of tax rates on corporate dividend payments to 15 percent.
- Reduction of the tax rates on long-term capital gains from 20 percent in the top bracket and 10 percent in lower brackets to 15 percent and 5 percent, respectively, with the lower rate declining to zero in 2008.
- A further increase in the AMT exemption.

For tax years 2003 and 2004, the tax cut more than doubled the impact of President George W. Bush's 2001 package, raising the total savings for city residents to $11 billion over the two years.[16] For New York City filers with adjusted gross incomes over $125,000, the added federal tax cut was roughly two and a half times the combined State and City tax increases.[17]

The federal tax cuts also helped to pump up city revenues in other ways. With very few differences, the New York State and City income tax base is the same as the federal income tax base—and therefore can be greatly affected when taxpayers alter their behavior in response to changes in federal tax rates. The most vivid past example of this phenomenon was the sharp rise and fall of state and city revenues when the federal government raised its capital gains rates in the late 1980s. Likewise, the 1990 and 1993 increases in federal income tax rates in upper brackets led to slower growth in taxable incomes, which in turn would have suppressed the growth in State and City income tax revenues.[18]

By the same token, sharp and immediate decreases in federal rates generally encourage households—especially the wealthy—to expose more income to taxation. Federal tax rate discounts on income from dividends and long-term capital gains encouraged more taxpayers to make money in these categories, which the state and city continue to tax at the same rates as wage income. The predictable result: even after adjusting for rate hikes, state and city income tax receipts grew sharply above projections.

In retrospect, it would have been difficult to come up with a federal tax cut better tailored than JGTRRA to meet the needs of New York City, in particular, under the conditions that prevailed there in 2001–03. The accelerated marginal rate cuts pumped billions of dollars into the pockets of New Yorkers who might be considered "wealthy" elsewhere, along with tens of thousands of entrepreneurs and small-business owners. The reduction in taxes on dividends and capital gains were a tonic for the securities industry, which accounts for an estimated one-quarter of the City's economic activity and nearly one-fifth of its wage income.[19]

Can anyone here spell R-E-L-I-E-F?

Aside from the mayor's unsuccessful bid to shift a good portion of the city's personal income tax to commuters in 2003, the city has made three stabs at tax relief in the past three years – two of which do not actually reduce rates for taxpayers. These included:

- A $400 annual payment[20] to homeowners characterized by the Mayor in his 2005 State of the City address as "our thank you for being there when the city needed you." The current level of this "tax rebate" corresponds to the average increase in property taxes resulting from the 18.5 percent rate hike. The state statutory provision giving the city authority to issue rebate checks expires in fiscal 2007.
- A $50 million expansion of the earned income credit. While it is widely considered an effective wage subsidy for the working poor, the credit flows to people who owe little or nothing in taxes to begin with.
- Renewal of the city sales tax exemption on clothing purchases under $110, effective September 1, 2005 - restoring a city tax cut previously effective from 2000 to 2003.

The so-called property tax rebate could more accurately be described a transfer payment to homeowners at the ultimate expense of commercial property owners and apartment renters.

Economic Impacts

A clear pattern emerges from a review of city tax changes over the past 40 years: tax increases coincide with job losses relative to national levels, and tax cuts coincide with job gains. This is especially true when the value of state income tax cuts is factored into the mix.

The link between taxes and jobs was further highlighted in a recent economic study of revenue trends in four major cities—New York, Philadelphia, Houston, Minneapolis.[21] The study found, among other things, that a large share of New York's job losses since 1970 could be attributed to increases in its income tax during that period.

The Manhattan Institute first sought to independently document the link between taxes and employment in New York City in 2001, using the State Tax Analysis Modeling Program (STAMP) developed by the Beacon Hill Institute in Boston. As documented in a September 2001 report,[22] the STAMP model indicated that reductions in the City's personal income, sales, business and property taxes had generated more than 80,000 new jobs between 1997 and 2001, or about one of every four gained by the City during that period.

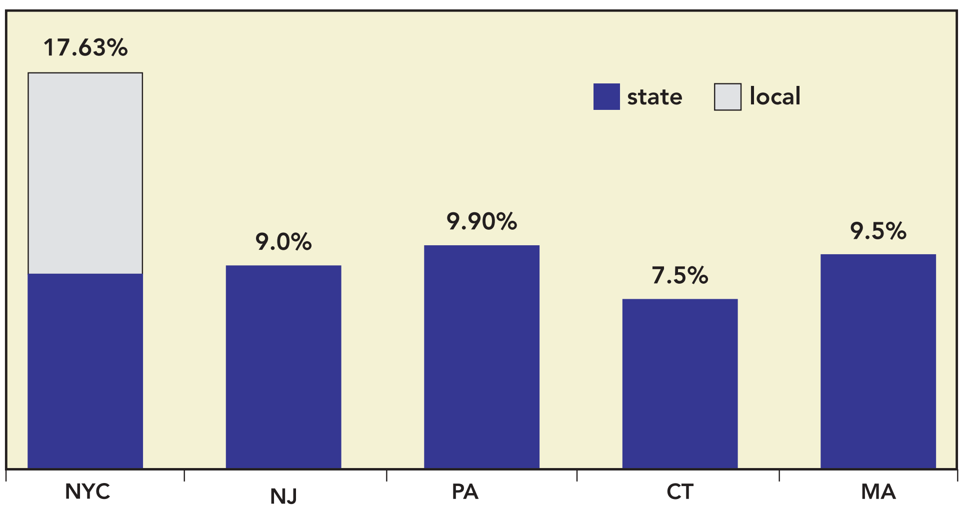
To explore the impacts of more recent changes in city tax policy, the Manhattan Institute's Empire Center for New York State Policy has commissioned an updated and upgraded version of STAMP, this time as a computable general equilibrium (CGE) model. Preliminary findings of NYC CGE STAMP 2005, which will be detailed in a forthcoming Special Report of the Empire Center, indicate that the federal tax cuts created far more jobs in New York City than the state and local tax hikes destroyed in 2003 and 2004.

Structural issues and skewed distributions

While the level of city taxes has clear implications for economic growth, the structure of taxes also affects the city's fiscal stability. And the structure in New York is exceptionally complicated. The Big Apple is the only major city to impose its own personal income tax along with three different forms of business income tax, in addition to the more typical urban array of real estate, sales and excise taxes. Taxes unique to New York City include:

The **general corporation tax**, which is imposed at a rate of 8.85 percent on the net income at all corporations (except banks) for the privilege of doing business, employing capital, or maintaining an office in New York. This tax is imposed on top of the state's corporate franchise tax, whose top rate reaches 8.775 percent in the city. As a result, the combined marginal corporate tax rate in New York is an astounding 17.625 percent – easily the highest in the nation. (see Figure 2 for regional comparison).

Figure 2. Corporate Tax Rates, 2005



Source: Federation of Tax Administrators, author's calculations

The **banking corporation tax**, which is imposed at varying rates[23] on banks doing business in the city – in addition to the New York State banking tax, which it closely resembles

The **unincorporated business tax** (UBT), imposed at the rate of 4 percent on the profits of all sole proprietorships and business partnerships doing business in the city. Because firms are not allowed to claim a deduction for profit distributions to partners or owners, the UBT effectively is a form of income tax imposed on partnership shares at the firm level. Under the temporary income tax rates prevailing in 2005, this effectively raises the marginal state and local income tax rate on the profit shares of New York's best-paid lawyers, investment bankers, physicians and sole proprietors to 11.7 percent for non-residents of the city[24] and 16.15 percent for city residents.

The **commercial rent tax**, which is imposed at an effective rate of 3.9 percent on base rents exceeding $250,000 for space located below 96th Street in Manhattan. The commercial rent tax in the outer boroughs was eliminated in 1996.

These four taxes all share something in common: they have evolved over time as part of multi-faceted effort by city government to tax every wealth-creating activity that takes place within its borders, with little regard for the impact on the cost of doing business.

Personal income tax: where the money is

Of course, the ultimate wealth tax is the city's resident personal income tax, which dates back to 1966. With few minor exceptions, the city income tax base is the same as that of the state income tax, and the two taxes are collected together by the state Department of Taxation and Finance, based on filings of state income tax forms.

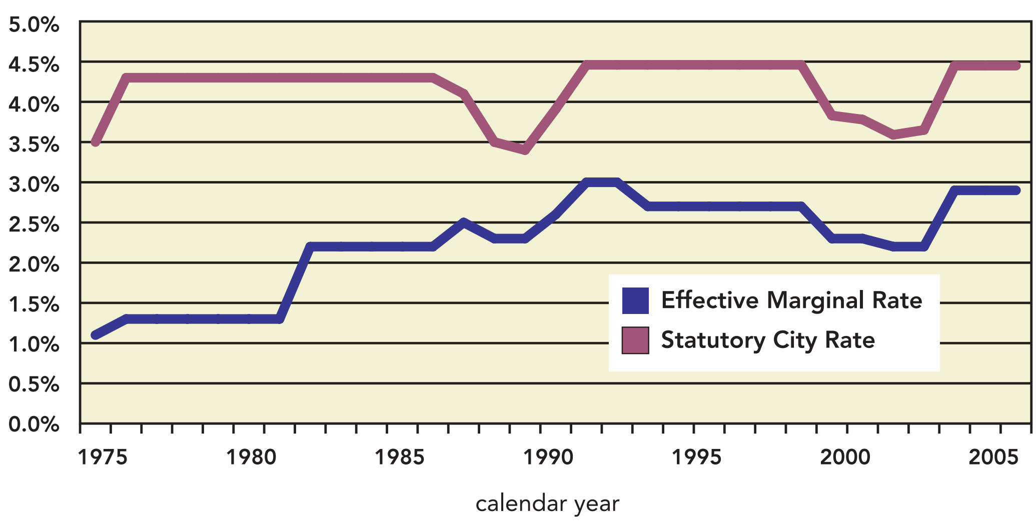
As shown in Figure 3, the temporary top rate in the city income tax since 2003 is nearly equal to the all-time high of 4.46 percent, which prevailed from 1991 through 1998. The statutory rate was also above 4 percent from the mid-1970s through 1986, but as shown in the chart, the effective rate during this period was much lower, once the deductibility of the tax on federal returns was taken into account. The reason: federal marginal rates were significantly higher prior to the 1981 Reagan cuts and 1986 federal tax reform act, and so the net cost of the city rate was lower.

The exclusion of state and local tax deductibility under the federal Alterative Minimum Tax raises the effective rate of the city taxes higher for a growing number of affluent and middle class New York filers. The solution recently offered by the President's tax reform task force – repeal of the AMT, coupled with repeal of state and local tax deductions – will put even more pressure on the city to lower its rates.

City income tax burden – heaviest at the top

Like the federal and state incomes taxes, the city resident income tax is imposed at gradually rising rates. The city's bracket structure is different from the state's, requiring tax filers to consult two different rate

Figure 3. New York City Personal Income Tax Rate*
Effective (Post-Federal Deduction) and Statutory Top Rates on Wage Income 1975-2005



Source: City of New York Offfice of Management and Budget, Tax Foundation, author's calculations.

tables, but the results are similar in terms of the tax burden's distribution. In both cases, income tax rates rise steeply with income, and disproportionately high shares of city income tax are generated by the wealthiest taxpayers.

As shown in Table 2, households with incomes above $1 million a year are now estimated to generate a full one-third of the city's income tax revenue. Households earning more than $250,000 make up 2.3 percent of all filers but generate over half the income tax. These relative shares were not much different before the temporary rate increases were imposed in 2003.

Table 2. The New York City Personal Income Tax: Who Pays How Much (Brackets shown are for married/joint filers)

Income* range	Share of Taxpayers	Share of Income*	Share of Tax Liability
< $50,000	68.9%	24%	10%
$50,001 to $75,000	13.8%	13%	11%
$75,000 to $100,000	6.7%	9%	9%
$100,000 to $125,000	3.4%	6%	6%
$125,001 to $250,000	4.9%	13%	14%
$250,000 to $500,000	1.4%	7%	10%
$500,000 to $1,000,000	0.5%	6%	9%
Over $1,000,000	0.4%	21%	32%

* Federal adjusted gross income

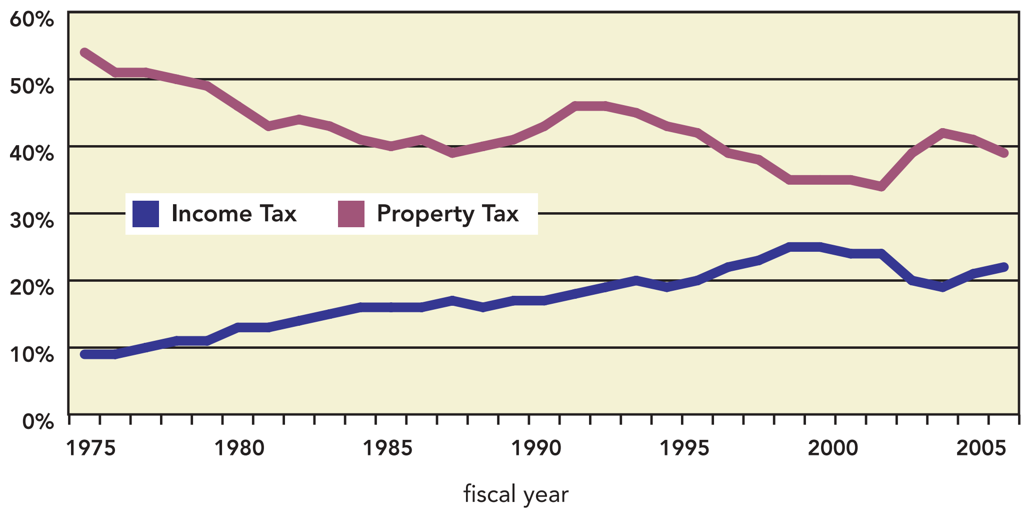
Taxpayers earning over $1 million make up less than half of one percent of the total (about 12,000 filers out of more than 3 million) while accounting for nearly one-third of the city's income tax revenues

Source: Independent Budget Office

This distribution of taxes reflects a fundamental problem with the city's level of reliance on the income tax. Wealthier households have far more volatile incomes than most taxpayers — as was vividly demonstrated in fiscal 2002, when New York City's income tax collections plunged by $1.2 billion largely as a result of capital losses sustained by high-income investors. In 2003, personal income taxes dropped by another $63 million. The two-year trough in this category was a key factor in the huge budget gaps that dominated Bloomberg's first two years in office. By remaining so heavily dependent on the personal income tax, the city leaves itself acutely vulnerable to future market downturns affecting high-income investors.

That vulnerability has grown sharply over the past 30 years. As regional economists for the Federal Reserve Bank of New York noted in a 2004 paper on the city's tax system, the shift to a greater dependence on personal and business income taxes "has made the city's tax revenues less stable than the revenues of the 1970s and more sensitive to cyclical swings."[25] A portion of this shift is illustrated in Figure 4, showing the decline in the property tax share of tax revenue and the increase of the personal income tax share over the past 30 years.

Figure 4. Income Taxes and Property Taxes as Shares of Total City Tax Revenue 1975-2005



Source: Federation of Tax Administrators, author's calculations

The implications of these trends should make city officials more sensitive to the high stakes of soak-the-rich policies urged on them by many of the city's left-leaning advocacy groups. If a change in marginal rates proves sufficient to drive 5 percent of the million-dollar-plus filers to move elsewhere, it will translate on average into a loss of 1.5 percent of total income tax revenue – or $100 million.

The skewed property tax

While all cities have real property taxes, few if any could rival the complexity, inequity and opacity of New York City's system.

While the city's property tax rates are set by local law, the structure of the tax is determined by state law. And since 1981, that law has allowed the tax to be assessed and levied at different rates on four different classes of property, as summarized in Table 3 below.

Class 1 residential properties account for 53 percent of market value, but only 11 percent of billable assessed value, and the "class share" of the tax levy for this group of properties is just 15 percent. This is the main reason why New York City homeowners pay significantly lower property taxes than homeowners in neighboring suburban counties – a difference offset for many homeowners by the existence of a city income tax, which has no equivalents in the suburbs. Class 2 property, including apartment buildings as well as co-ops and condominiums owned by the people who live in them, are taxed far more heavily. Moreover, "there are very wide disparities in the tax burdens not just between Tax Class 1 and Tax Class 2, but within the coop and condo class, as well," as the Independent Budget Office has pointed out.[26]

Table 3. Distribution of City Real Property Taxes by Property Class

	Class Shares of …		
	market value	billable assessment	tax liability
Class 1	53%	11%	14%
Class 2	21%	35%	35%
Class 3	3%	7%	7%
Class 4	23%	41%	44%

Class 1: one-, two- and three-family residences and small condominiums
Class 2: apartment buildings, co-ops and larger condominiums
Class 3: utilities
Class 4: commercial

Source: City of New York, Office of Management and Budget

At the other extreme, commercial properties account for 23 percent of market value, but make up 41 percent of the billable assessment and are assigned a class share of 43 percent of the property tax levy. As of fiscal 2005, this translated into $875 million of the nearly $2 billion in added property taxes resulting from the 2003 rate increase. Because most commercial leases contain a “pass-through” provision, the property tax hike translated into an immediate increase in rent. Adding insult to injury for the largest, most heavily taxed office tenants in Manhattan, the rent increase was subject to commercial rent tax. (In fact, CRT revenue attributable solely to higher property taxes is projected at nearly $16 million for fiscal 2006. In other words, the 18.5 percent increase in the property tax has driven a 3.5 increase in the commercial rent tax receipts.)

The resulting tax on New York’s most valuable commercial property, prime office space in Manhattan, is extraordinarily high compared to the rates in most other big cities, as shown in Figure 5.

Figure 5. Taxes on Prime Office Space in Major Urban Areas, 2003

Source: Studley Effective Rental Index

SETTING SUNS?

Will the income tax rates temporarily created in 2003 be allowed to "sunset" on schedule at the end of 2005? This is probably the single most important tax policy question facing city and state officials in the six months ahead. While the two temporary added rates are scheduled to expire at the end of the calendar year, the danger of a retroactive extension will remain when the state and city budgets are being formulated and adopted in the spring of 2006.

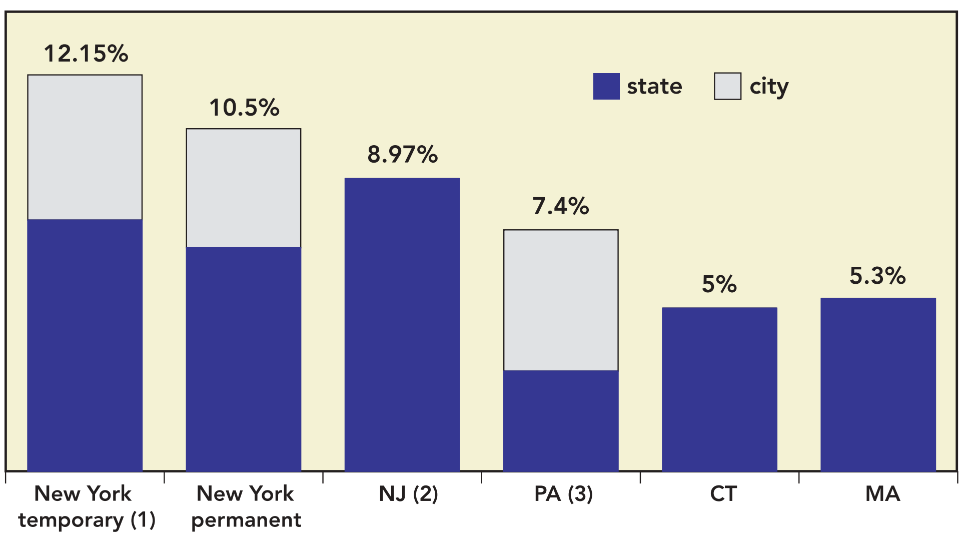
So far, the reductions in the second-highest temporary income tax rates on the state and city income taxes have taken place on schedule, in 2003 and 2004. Governor George Pataki appears strongly committed to ensuring that the temporary state income tax is not extended at any level.

The Mayor, meanwhile, pledged in his 2004 State of the City address that since the city's cash position was strong, "the surcharge on the personal income tax is going to 'sunset' on schedule." More recently, however, he reportedly "indicated that, if his record on tax increases was any guide, he might turn to the city's wealthy elite in a second term to avoid budget cutbacks."[27]

The city's projected budget gap for fiscal 2007 exceeded $4 billion as of July 2005. This amount will likely shrink due to increases in revenue estimates before the next budget is presented, but the shortfall will remain sizeable enough to force the mayor to confront some of the toughest budget-balancing choices he has faced since 2003. But extending the temporary top rate will do little to solve the problem; in conventional static terms – i.e., not taking account of any behavioral changes by taxpayers unwilling to sit still for the hike— it would be valued in the neighborhood of $500 million.

As illustrated in Figure 6, the combined state and local income tax rate shouldered by New York City residents will remain the highest in the region even if the temporary top rates expire on schedule.

Figure 6. Personal Income and Wage Taxes
Top Marginal Rates in New York and Closest Neighboring States



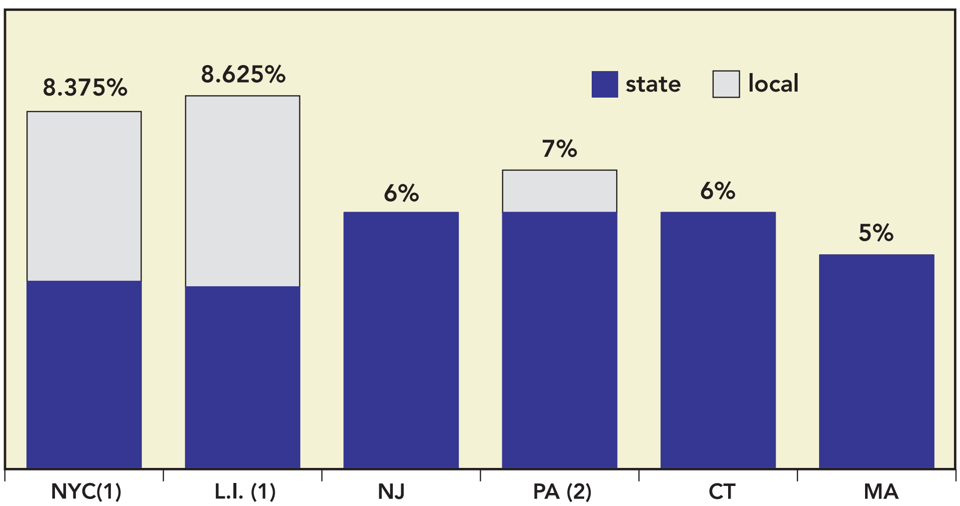
(1) Temporary NY rates, applicable on a flat-rate basis to the total incomes of filers with taxable incomes over $500,000, are scheduled expire at the end of 2005.
(2) Top rate applies to taxable incomes above $500,000.
(3) City rate shown is for Philadelphia.

Source: Federation of Tax Administrators

The temporary added sales tax rates of 2003 expired as scheduled, on July 1, 2005. However, it was immediately replaced by another 0.162 percent sales-tax add-on – this one imposed by the state on a regional level, to underwrite mass transit improvements. The combined state-local sales tax in the city now stands at 8.375 percent – exceeded within the region only by the sales taxes imposed by Nassau and Suffolk counties on Long Island, as shown in Figure 7.

One other "sunset" issue: As noted, the statutory authority for the city to offer the property tax rebate expires at the end of fiscal 2007. Rebates and other special tax exceptions may make effective politics, but in general are recognized as bad tax policy. The fairest and most economically efficient approach would be to convert the rebate into a $265 million across-the-board rate cut, as Council Speaker Gifford Miller unsuccessfully urged in 2004.

Figure 7. State and Local Sales Tax Rates (as of July 1, 2005)



(1) State rate includes regional mass transit surcharge of 0.375%.
(2) Local rate shown is for Philadelphia.

Source: Federation of Tax Administrators, New York State Department of Taxation and Finance.

Conclusion

Ironically, while New York’s tax code has been engineered to strip-mine the world’s largest concentration of corporate and individual wealth, the city government is chronically unable to make ends meet. Recurring expenditures now exceed recurring revenues by well over $3 billion, according to the mayor’s most recent estimate of the municipal government’s “structural” budget deficit. Attempting to close this gap with new permanent tax hikes would requiring raising the tax burden a big step closer to the economically hyper-destructive levels of the 1970s.

Moreover, aside from being unduly burdensome, the city’s tax structure is in many respects economically inefficient, inequitable and cumbersome to administer – problems that have only become worse in recent years.

Except for a few years in the 1990s, city officials have long tended to view taxes primarily as an instrument for redistributing income, rewarding favored voter blocs, or pursuing social goals. The budgetary default position is to spend up to whatever level of revenue is projected – and to raise rates when revenue falls short. That approach needs to change. To generate the economic growth needed to sustain basic public services, New York’s leaders should commit themselves to both reducing taxes and reforming the tax structure. Their goal should be the optimum combination of fiscal stability, economic efficiency, and – last but not least — competitiveness.

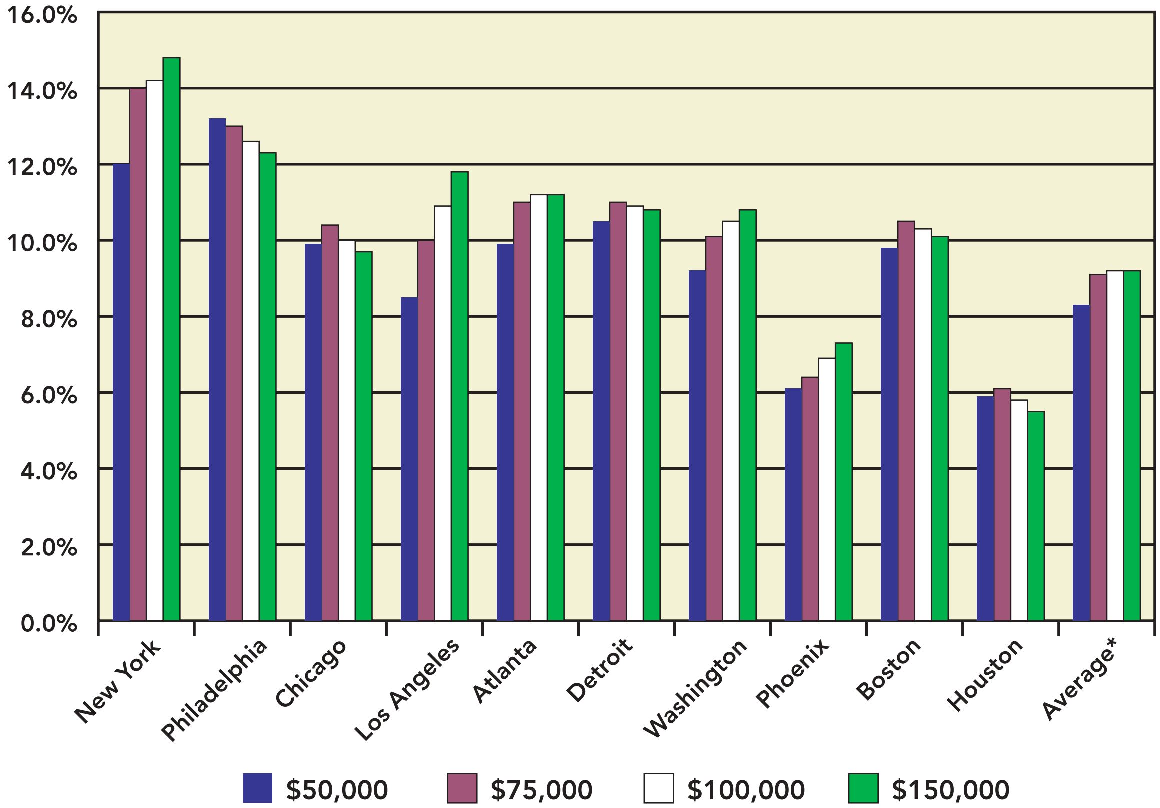
These suggest a few priorities for the immediate future:

- Keep the implicit promise to taxpayers and allow the temporary income tax rates to sunset on schedule.
- Convert the misleadingly named “property tax rebate” into an across-the-board cut for all property classes.
- Declare a moratorium on further tax increases in what is, by every available measure, the nation’s most heavily taxed big city.
- Appoint a joint state and city commission to recommend reform and simplification of the city’s notoriously byzantine property tax structure.
- Begin a long-term effort to reduce and simplify business taxes, starting with a renewed commitment to repealing the smallest of these levies, the commercial rent tax.

Changes in the property tax structure carry enormous implications for middle-class homeowners. As shown in Figure 8, even given their relatively low property taxes by regional standards, these families bear an exceptionally heavy state and local tax bill compared to their counterparts in other major cities. For most typical families already grappling with all the other more costly aspects of living in New York (such as housing and electricity, to name just two), the combined tax bill is thousands of dollars higher than they would pay on the same income to live in Chicago, Los Angeles, or Atlanta, to cite just three examples. Shifting more the burden to Albany – an alternative favored by city officials – won’t significantly change this picture.

More fundamental changes will necessarily involve far more significant revenue impacts that would not be easily absorbed by the city budget in the short run. Tax reform – setting a winning price point for Bloomberg’s “luxury product” of a city — ultimately is not possible without a commitment to streamlining and reforming city services.

Figure 8. Estimated Burden of Major State-Local Taxes
Families of Four at Different Income Levels in Selected Large Cities



Source: District of Columbia, Chief Financial Officer

Endnotes

[1] “Mayor Says New York is Worth the Cost,” The New York Times, Jan. 3, 2003, p. B3.

[2] Mayor John V. Lindsay responded to the 1969 recession with a series of damaging new tax hikes, including a 75 percent increase in the city’s personal income tax rate, a penny-per-dollar increase in the city’s sales tax, and an expansion of the UBT to capture the partnership profits of physicians, lawyers and other professionals. These rate hikes were large enough to push up net city tax receipts by 53 between fiscal 1970 and 1975, even though the city was hemorrhaging private sector jobs. But they still weren’t enough to keep up with the growth in the budget, which expanded by an incredible 80 percent in the same period. The tax hikes nudged the city into economic free-fall. When Lindsay’s second term began in 1970, total city taxes were slightly below 8 percent of personal income. By 1977, this figure had soared to well over 10 percent. During the same period, the city lost an incredible 600,000 jobs.

[3] “Report by the Chief Economist, Comptroller’s Budget Office, on the Impact of the Local Tax Burden on New York City,” Stephen Kagann, Ph.D, Chief Economist and Zheng Gu, Ph.D, Senior Economist, April 1991.

[4] To be sure, Giuliani’s pro-tax-cut philosophy was not consistently applied. After eliminating the city’s commercial rent tax (CRT) in outer boroughs, he favored retaining the tax in Manhattan and using the proceeds to finance construction of a new Yankee Stadium on the West Side of Manhattan. The proposal ultimately got nowhere, but it effectively stalled repeal of the remaining CRT, which is still in effect.

[5] This number needs to be kept in context. On the city’s 2001 tax base, the Dinkins-era increases cost the city’s resident taxpayers and property owners at least $1.8 billion — including $400 million in increased property tax rates, and $1.4 billion from the two income tax surcharges. The net, self-initiated changes in city taxes since 1990 added up to, at best, a token cut of $400 million, including a short-lived fiscal 2002 reduction in the personal income tax surcharge.

[6] The combined state and city personal income tax rate in New York dropped for five out of six years between 1995 and 2002. Solely as a result of state actions, the combined corporate income tax rate dropped almost every year from 1994 to 2002. The state also killed several taxes that fell especially heavily on New York City, including the “Cuomo tax” on large real-estate transactions, the state hotel-room tax, and the added estate and gift tax.

[7] Personal income reflects only a portion of the actual city tax base – which, after all, includes corporate income and the purchases of non-residents. But in the absence of an authoritative, long-term measure of gross city product, personal income is the best available proxy for the city’s economy.

[8] The estimated tax burden under Giuliani excludes fiscal 2002, which was affected by the sudden and precipitous drop in tax revenues after the World Trade Center attack.

[9] The tax cut in question was the beginning of as partial phase-out of a 14 percent income tax surcharge enacted in 1990.

[10] Testimony by Mayor Bloomberg During Public Hearing on Local Law (Pre-Considered Introductory Number 230-A), July 30, 2002.

[11] Details of the trend in cigarette tax collections can be found on page 86 of the Mayor’s Executive Budget Message for 2006.

[12] “Cigarette Smuggling Linked to Terrorism,”Washington Post, June 8, 2004, p. 1

[13] At the time they voted for repeal of the commuter tax, state Senate Republicans and Assembly Democrats were vying to influence the outcome of a special election for a vacant Senate seat in suburban Rockland County.

[14] The state income tax itself is a commuter tax imposed on all wage and salary income earned in New York State, regardless of the taxpayer’s place of residence.

[15] For details on the bizarre twists and turns introduced to the city tax code by the 2003 income tax statute, see the Manhattan Institute’s online FiscalWatch Memo of June 9, 2003, “New York’s Ugly Stealth Tax Hikes,” posted at http://www.nyfiscalwatch.com/html/fwm_2003-07.html.

[16] See E.J. McMahon, "The $36 Billion Bonus: New York's Gains from Federal Tax Cuts," Civic Report No. 43, Manhattan Institute Center for Civic Innovation, August 2004.

[17] In the aggregate, the Manhattan Institute's federal tax policy simulation model indicated that that households in New York City with incomes above $125,000 saved nearly $2 billion in federal income taxes while paying about $410 million more in City income taxes and about $420 million more in State income taxes.

[18] For more on this phenomenon, see Robert Carroll, "Do Taxpayers Really Respond to Changes in Tax Rates?", U.S. Treasury Office of Tax Analysis, OTA Working Paper 79, November 1998.

[19] Securities Industry Association, "The Street, the City, and the State: The Securities Industry's Importance to New York City and State," Securities Industry Trends 40, no. 2 (March 22, 2004), from cover page highlights. Ibid., p. 12.

[20] Homeowners who pay less than $400 in property taxes receive a check equivalent to their property tax bills.

[21] Andrew Haughwout, Robert Inman, Steven Craig, and Thomas Luce, "Local Revenue Hills: A General Equilibrium Specification With Evidence From Four US Cities," NBER Working Paper 7603, March 2000.

[22] Edmund J. McMahon, "What New York Has Gained From Tax Cuts," Civic Report No. 20, Manhattan Institute Center for Civic Innovation, September 2001.

[23] The bank tax is based on three alternative calculations, of which the bank pays the greatest amount.

[24] The UBT also functions as a form of indirect commuter tax – refuting the common argument that the city does not tax any commuter income.

[25] Jesse Edgerton, Andrew F. Haughwout and Rae Rosen, "Revenue Implications of New York City's Tax System," Current Issues in Economic and Finance, Federal Reserve Bank of New York, April 2004, Volme 10, No. 4.

[26] City of New York, Independent Budget Office, "Testimony of George Sweeting Before the City Council Finance Committee On the Tax Treatment of Coops and Condos," February 26, 2004.

[27] "3 Democrats and Mayor Vie for Third Party's Nod," The New York Times, May 12, 2005, p.B3.

The Center for Civic Innovation's (CCI) purpose is to improve the quality of life in cities by shaping public policy and enriching public discourse on urban issues.

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